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IN THE

Supreme Court of the United States

OCTOBER TERM, 1969

No. 1448

IN THE MATTER OF
THE CENTRAL RAILROAD COMPANY OF NEW JERSEY,
Debtor.

JOHN E. FARRELL, TRUSTEE OF THE PROPERTY OF THE CENTRAL RAILROAD COMPANY OF NEW JERSEY,
Petitioner,

vs.

MANUFACTURERS HANOVER TRUST COMPANY, TRUSTEE OF THE GENERAL MORTGAGE WHICH SECURES THE GENERAL MORTGAGE BONDS OF THE DEBTOR,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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MANUFACTURERS HANOVER TRUST COMPANY, TRUSTEE OF THE GENERAL MORTGAGE WHICH SECURES THE GENERAL MORTGAGE BONDS OF THE DEBTOR,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

Petitioner, John E. Farrell, Trustee of the property of The Central Railroad Company of New Jersey, prays

that a writ of certiorari be granted to review the decision of the United States Court of Appeals for the Third Circuit rendered in this action on January 19, 1970; petition for rehearing denied February 18, 1970.

Citations to Opinions Below

The memorandum and order filed March 26, 1969, in the United States District Court for the District of New Jersey, printed in Appendix A hereto, *infra,* p. 1a, *et seq.*, is not officially reported. The opinion of the Court of Appeals for the Third Circuit, reversing the decision of the District Court is also not reported. It is printed in Appendix B hereto, *infra,* p. 6a, *et seq.*

Jurisdiction

The opinion of the Court of Appeals for the Third Circuit together with said court's judgment was rendered on January 19, 1970. Rehearing was denied on February 18, 1970. The jurisdiction of this court is invoked pursuant to 28 U. S. C. Section 1254(1).

Questions Presented

1. Is Petitioner, who is the Trustee of a railroad undergoing reorganization pursuant to Section 77 of the Bankruptcy Act, allowed to use funds representing security under a general mortgage of the Debtor's, to remove a damaged drawbridge which represents a hazard to the continued operation of the railroad?

2. Should the bondholders of a railroad in reorganization have a duty to contribute to the reorganization of a Debtor's estate for a period of time sufficient to allow an adequate attempt at reorganization?

3. Must a "betterment" be a physical improvement to property or are funds spent to preserve and protect the corpus from a real threat of physical harm of such a nature that they are a *de facto* "betterment"?

4. Assuming the opinion below is correct in holding that the Trustee in reorganization has an obligation to repay the mortgage security funds withdrawn from Special Bank Account No. 3, was the court below correct in compelling petitioner to repay said funds with interest, in light of the fact that had the funds remained in Special Account No. 3 any interest generated by said funds would have been withdrawn and used by petitioner?

Statute Involved

The statutory provision involved is the Bankruptcy Act, Section 257, 11 U. S. C. Section 657, printed in Appendix C, *infra,* p. 18a.

Statement of the Case

On March 22, 1967, The Central Railroad Company of New Jersey, hereinafter referred to as the Debtor, filed a petition in the United States District Court for the District of New Jersey seeking reorganization pursuant to Section 77 of the Bankruptcy Act, 11 U. S. C. Section 205 (J.A. 1a).[1] On said date an order was signed by the Honorable Anthony T. Augelli approving the reorganization petition and continuing the Debtor in possession (J.A. 5a).

During the course of the administration of the Debtor's estate Mr. John E. Farrell was appointed Trustee by the United States District Court with the approval of the Interstate Commerce Commission.

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[1] Refers to Joint Appendix filed in the Third Circuit.

On May 19, 1966 the S.S. WASHINGTON collided with the Newark Bay Drawbridge owned by the Debtor. This bridge crosses Newark Bay and connects the cities of Elizabeth and Bayonne, New Jersey and it is Debtor's only rail link with the New York Harbor (J.A. 60a). The collision resulted in considerable damage to the bridge, in fact rendered the bridge inoperable for railroad traffic from the date of the accident to June 1, 1966 (J.A. 29a).

The structure in question is actually two parallel bridge spans as can be seen in Trustee's Exhibit TR-2 (J.A. 86a).

The accident in May of 1966 damaged the northerly lift span. Trustee's Exhibit TR-2 (J.A. 86a) indicates with "B" the point where the ship struck the bridge and with "A" the point at which the lift span of the northerly tower became jammed as a result of the impact (J.A. 56a). Prior to the collision, the lift span in question could be raised 135 feet above mean high water, after the accident it was jammed at 127 feet above mean high water (J.A. 56a-57a).

By petition directed to the District Court the Trustee in reorganization sought to remove the damaged lift span (J.A. 43a). Debtor's Chief Engineer testified that the lift span in its then position constituted a real threat to water traffic as well as freight and passenger traffic using the south span of the bridge (J.A. 64a). Should the jammed span fall and strike the parallel south span of the bridge and remove it from operation, Debtor would lose its access to the New York Harbor (J.A. 62a).

The District Court after hearing the evidence before it made the following factual determination:

> "In the present case, the Court finds that there is an immediate and urgent need for the money to remove and dispose of the damaged portion of the north span of the Newark Bay Drawbridge. The Court further finds that there are no other sources available from which the necessary funds for this expenditure can be obtained. * * *" (J.A. 95a)

Based on these facts the court below felt it was imperative that the Trustee be allowed to obtain the necessary funds to make the essential removal of the bridge in question. The court also found with respect to the ultimate chances of reorganization that:

> "For the reasons stated herein, the Court finds that reorganization is probably feasible and that the interests of the bondholders are not prejudiced by granting the relief herein requested. * * *" (J.A. 96a)

After reviewing the above factual findings the District Court by Memorandum and Order dated March 26, 1969, authorized the Trustee to enter into a contract with the Wrecking Corporation of America for the removal of the jammed lift span and authorized the Trustee to withdraw $408,000 to pay for said work out of funds on deposit in Special Account No. 3 (J.A. 97a).

Special Account No. 3 is the account in which proceeds of land sales negotiated by the Debtor in excess of $10,000.00 are deposited. These proceeds are all subject to the liens of Debtor's mortgages.

The United States Court of Appeals for the Third Circuit reversed the determination of the District Court holding that the reorganization Trustee should be required to repay the funds withdrawn from Special Ac-

count No. 3. The basis of this decision was that the bondholders' lien had priority over the claims of operations creditors. In support of this contention the Court refers to *In re New York, New Haven & Hartford Railroad*, 278 F. Supp. 592 (D. C. Conn., 1967). Based upon this opinion the Circuit concluded:

> "Prior to the district court's order, the Indenture Trustee possessed a mortgage lien upon the funds in Special Account No. 3. This bondholders' lien had priority over the claims of operations creditors. The order, however, released $408,000. from stockholders' lien, thus making that amount available to satisfy the priority of operations creditors. Equity demands that the bondholders be given a guaranty that their lien upon this money be maintained, and that the money be repaid as soon as reasonably possible. Cf. *In re Riker Del. Corp.*, 385 F. 2d 124, 125 (3rd Cir. 1967).
>
> "Therefore, the District Court order of March 26, 1969, will be reversed and that court will be directed to enter an order
>
> (1) imposing upon the Reorganization Trustee an obligation in favor of the Indenture Trustee, ranking on a parity as to lien and priority with any other obligations (except Trustee certificates approved by the Interstate Commerce Commission) heretofore or hereafter incurred by the Reorganization Trustee, for repayment of the $408,000. principal drawn-down from Special Account No. 3, in such installments as the District Court shall determine to be reasonable, any part of such $408,000. principal so repaid to have the same status as other funds in Special Account No. 3;

(2) providing for interest payments on all of the above-mentioned $408,000. from the date or dates of its payments by the Indenture Trustee and on such parts of this $408,000. as have not been repaid in the future at such rate as the District Court shall determine from time to time, but in no event shall such rate be less than the average rate of return on the principal funds within Special Account No. 3, the obligation to pay such interest ranking on the same parity as to lien and priority as is specified in (1) above; and

(3) providing that the interest paid on the above-mentioned $408,000. and parts thereof, prior to repayment of the principal producing such interest, shall be income of the Indenture Trustee."

In the petition for rehearing it was pointed out to the Court that while at oral argument there was some confusion as to who is entitled to the interest on Special Account No. 3 funds, it was unequivocally stated in the Petition for Rehearing that throughout all the past dealings between the Reorganization Trustee and the Indenture Trustee, all interest generated by Account No. 3 funds has been turned over to the Reorganization Trustee for his use as operating funds. Rehearing was denied February 18, 1970.

Reasons for Granting the Writ

1. The decision of the Court of Appeals in this case is contrary to all prior decisions of the several circuits as well as prior decisions of this Honorable Court. The Third Circuit has held, on page 8 of its opinion, that "a bondholders' lien had priority over the claims of operations creditors." In support of this statement the court

refers to *In re New York, New Haven & Hartford Railroad,* 278 F. Supp. 592 (D. C. Conn., 1967). This assumption is wrong and is grounded upon a misinterpretation of the New Haven opinion.

The funds *sub judice* were removed from a mortgage security account and used to pay an operating expense that was incurred by the Trustee in Reorganization. This obligation was an administrative claim and as such was entitled to payment prior to the mortgage. It has been held by this court that administrative expenses such as wages, repairs and cost of preserving the estate all will be given priority over those liens which it may be said have benefited from the continued operation of the railroad. *Ecker* v. *Western Pacific Railroad Corporation,* 318 U. S. 448, 63 S. Ct. 692 at 714 (1943).

The principle that administration costs will be given priority over the mortgage liens has been upheld many times. *Matter of Chicago, Rock Island & Pacific Railroad Co.,* 90 F. 2d 312 (7th Cir., 1937), cert. denied 302 U. S. 717, 58 S. Ct. 37 (1937); *Central Hanover and Trust Co.* v. *Williams,* 95 F. 2d 210 (8th Cir., 1938); *Thompson* v. *Siratt,* 95 F. 2d 214 (8th Cir., 1938). See also 5 *Collier on Bankruptcy,* Section 77.21, note 20.

The Circuit Court of Appeals in relying on *In re New York, New Haven & Hartford Railroad,* 278 F. Supp. 592 (D. C. Conn., 1967) failed to understand that when Judge Anderson spoke of operations creditors, he referred to those creditors who contributed to the operation of the railroad in the six month period prior to the reorganization of the railroad and he was not referring to operating expenses which arise during the course of the administration of the Reorganization Trustee.

This fundamental misconception of the rights of the mortgage trustee pervades the Circuit Court opinion.

The court approached the problem before it with the presumption that the mortgage lien holders were sacrosanct and that their lien was of the first priority. The cases above show this was wrong and that administration claims come ahead of the mortgage.

A reorganization has as its purpose rehabilitation and not liquidation of a debtor's estate. This principle was recognized in the New Haven reorganization when the District Court allowed daily losses to accumulate. The bondholders in New Haven objected stating that the day to day operational losses were prior to the mortgage lien and that by continuing the railroad in operation the court was diminishing the bondholders' security. The court stated that bondholders of a railroad are subject to having their security interests invaded to the point where the invasion may be essential to continue the operation of the railroad for a reasonable time so that a plan may be formulated. The court in *New Haven* was quick to point out that at some point the diminution of the mortgage security might constitute an unconstitutional taking of property. However, for a reasonable time and up to a reasonable amount the mortgage security could be invaded. *In re New York, New Haven and Hartford Railroad Co.*, 289 F. Supp. 451 (D. C., Conn., 1968). This principle was ignored below.

Judge Anderson in support of his conclusion above in the *New Haven* opinion *supra* refers to this court's decision in *Penn Central Merger and N. & W. Inclusion Cases*, 389 U. S. 486 at 510, 88 S. Ct. 602 (1968), where the court held "while the right of the bondholders are entitled to respect they do not command Procrustean measures." This language was also cited by Judge Augelli in his District Court opinion *sub judice*. It is because of the failure of the Circuit Court to grasp this

point coupled with the court's misunderstanding of the status of the mortgage claim as against operating expenses incurred by the Trustee that the opinion below should be reversed.

The removal of the funds in question from Account No. 3 was the same as if the contractor who removed the damaged bridge had a contract claim for work performed against the Trustee. In both cases the work done was an operating expense of the Trustee and as such was entitled to payment before the mortgage lien.

The inconsistency of the Circuit Court ruling can be shown by the following. If the contractor had a claim against the Trustee as described above his claim with all other operating expenses would come ahead of the mortgage. The Circuit Court has in effect held that since the Trustee has used mortgage funds to pay an obligation that would stand ahead of the mortgage on liquidation that then the Trustee has an obligation to repay the mortgagee and that this obligation is ahead of all other operating claims (except Trustee's certificates). Applying this logic it would be in the best interest of the bondholders to advance sums to the Debtor up to the value of their mortgage because the Trustee's obligation to repay will come ahead of all the operating expenses that otherwise would come ahead of the mortgage. The Circuit Court has created a preference on behalf of the bondholders.

The Circuit Court has assumed that the Indenture Trustee has been harmed to the extent of funds withdrawn from Account Three. This is not so. Upon liquidation or reorganization all operating expenses arising under the Trustee's administration would be paid before one dollar of the mortgage lien would be satisfied.

2. The Circuit Court has held that the Trustee in Reorganization must repay all amounts withdrawn from Special Account No. 3 with interest. As the petition for rehearing states this ignores the fact that had the funds in question remained in Account No. 3 the interest generated thereby would be used by the Reorganization Trustee for operating expenses. The Circuit Court by misapprehending the role of the mortgagee in a reorganization has placed the bondholders in a better position vis a vis their fellow creditors than they would have enjoyed had the Trustee not used the funds in question.

This position by the Circuit Court ignores the cases that have held the secured creditors must contribute for a period of time to allow an attempt at reorganization. The Court below by holding that the interest to be paid by the Reorganization Trustee is to be income to the Indenture Trustee has threatened the very purpose of Congress in passing Section 77 of the Bankruptcy Act.

3. The whole question of the role of secured creditors in a railroad reorganization should be examined by this Court directly and explicitly. The Third Circuit has held that the security pledged under the mortgage stands prior to operating expenses upon distribution; this position is in direct conflict to prior case law as is developed in point one and the opinion below should be reversed. In addition, the question as to the amount of control a District Court judge may exercise over mortgage funds is an area that should be determined by this Court.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX A

Opinion of Augelli, C. J. U. S. D. C. (March 26, 1969)

(Filed—March 26, 1969)

MEMORANDUM AND ORDER

IN THE UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF NEW JERSEY

IN THE MATTER

of

THE CENTRAL RAILROAD COMPANY OF NEW JERSEY,

Debtor.

AUGELLI, Chief Judge:

This matter is before the Court on the Trustee's motion, heard on March 24, 1969, for an order authorizing the Trustee to enter into a contract for the removal and disposal of a damaged portion of the Newark Bay Drawbridge, and for permission to pay for such work out of funds taken from Special Account No. 3. This account was established by Order No. 58 in these proceedings, and is the account in which the Trustee deposits all proceeds of sale, salvage or other disposition of real property covered by the lien of Debtor's General Mortgage (except items involving $10,000.00 or less in any one transaction),

which proceeds are normally withdrawable by the Trustee to pay for needed additions and betterments to, or the purchase of, other real property, which would be or become subject to the lien of the General Mortgage. The Indenture Trustee of the General Mortgage and a Bondholders' Protective Committee oppose the Trustee's motion insofar as it would provide for payment of the work out of the Special Account without some obligation on the part of the Trustee to adequately secure the Bondholders under the mortgage.

It appears from the affidavit of the Trustee and from uncontradicted testimony adduced at the hearing that on May 19, 1966, the Steamship *Washington* collided with the Newark Bay Drawbridge, owned by the Debtor; that the present condition of the north span of the Bridge constitutes a hazard to navigation and a present and immediate danger to the Debtor's trains using the south span of the Bridge; that the Wrecking Corporation of America submitted the lowest bid to remove and dispose of the damaged portion of the north span under an option open until March 31, 1969; and that the Debtor is unable to obtain the necessary funds for the removal and disposition of this potentially hazardous condition through normal market channels.

It is apparent that it is imperative that the Trustee obtain the necessary funds immediately for this essential expenditure. Should this north span collapse, it would not only leave the Debtor open to an extreme risk of extensive liability, but it would also drastically curtail the operation of the Debtor and impede its rehabilitation.

The Court has considered the arguments of counsel and has read the cases cited in their respective briefs. While

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this Court is mindful of the strong policy favoring the preservation of a bondholder's security, it must, nevertheless, in the exercise of a sound and reasonable discretion, consider all of the factors relating to the reorganization of the Debtor. As was stated in another context in the *Penn-Central Merger* and *N. & W. Inclusion* cases, 389 U. S. 486, at 510, 511:

> "While the rights of the bondholders are entitled to respect, they do not command Procrustean measures."

Judge Anderson, in the early stages of the New Haven reorganization proceedings, in an unreported opinion, *In the Matter of the New York, New Haven and Hartford Railroad Company,* No. 30226 (D. Conn., filed Dec. 7, 1961), laid down the criteria for the invasion of the secured interest of the bondholders. In a later opinion, Judge Anderson recognized the need for a flexible approach to matters of this kind. See *In re New York, New Haven and Hartford Railroad Co.,* 289 F. Supp. 451 (D. Conn. 1968), where at 455, the court stated that:

> "Both the Commission and the courts, however, have reiterated in this and related proceedings that as bondholders of a railroad their interests are subject to such invasion as may be essential to continue the operation of the railroad for a reasonable period of time to provide an opportunity to work out a permanent plan or means of continuing the operation, if possible, to the extent that it is required by the public interest."

See also *Harding* v. *Stichman,* 240 F. 2d 289 (2 Cir. 1957).

Appendix A

In the present case, the Court finds that there is an immediate and urgent need for the money to remove and dispose of the damaged portion of the north span of the Newark Bay Drawbridge. The Court further finds that there are no other sources available from which the necessary funds for this expenditure can be obtained. There is no need for a lengthy expression by this Court of the public interest involved in keeping this railroad in operation. This is not to say that the Court will countenance further incursions into the Bondholders' security on any pretext or allegation of public need and continued operation of the railroad.

It may be argued that this expenditure is not for a "betterment" in the classic sense of the word; however, this Court has no doubt that the expenditure is necessary for the preservation of the property of this estate; it is, therefore, a betterment to the economic and efficient operation of the railroad. See *Central of Georgia Ry. Co.* v. *Central Trust Co. of New York,* 69 S. E. 708, 712, 135 Ga. 472. Unquestionably, the work to be done in this case will ultimately inure to the benefit of the bondholders. While there may be no tangible property added to the estate to which the lien of the bondholders can attach, the need for the preservation of the Debtor's estate in this instance cries out for protection. The Trustee has shown substantial progress in many areas with respect to the operation of this railroad. As freight revenues have increased, cash attrition has decreased. The Trustee has also initiated studies which seek further improvement in the operation and economy of the railroad. Undoubtedly the further viability of this system lies in a merger with a larger trunk line railroad. In this connection, the Court takes judicial notice of a report of

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Appendix A

I.C.C. Examiner Edward L. Boisseree to the Inter-State Commerce Commission, wherein he recommends the inclusion of the Debtor in the recommended merger of the Chesapeake & Ohio Railway into the Norfolk & Western Railway.

For the reasons stated herein, the Court finds that reorganization is probably feasible and that the interests of the bondholders are not prejudiced by granting the relief herein requested. Therefore, in the exercise of its discretion the Court concludes that the Trustee is authorized to enter into a contract with the Wrecking Corporation of America for the removal and disposition of the damaged portion of the north span of the Newark Bay Drawbridge, and to draw upon the funds in Special Account No. 3 for the payment of the same.

It is so ORDERED, on this 26th day of March, 1969.

/s/ ANTHONY T. AUGELLI
Anthony T. Augelli
U.S.D.J.

APPENDIX B

Opinion of the Court

(Filed—January 19, 1970)

UNITED STATES COURT OF APPEALS

FOR THE THIRD CIRCUIT

No. 17937

IN THE MATTER

of

THE CENTRAL RAILROAD COMPANY OF NEW JERSEY, Debtor.

MANUFACTURERS HANOVER TRUST COMPANY, Trustee of the General Mortgage Which Secures the General Mortgage Bonds of the Debtor,

Appellant.

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF NEW JERSEY

Argued November 18, 1969

Before HASTIE, *Chief Judge,* and VAN DUSEN ADAMS, *Circuit Judges*

Appendix B

By VAN DUSEN, *Circuit Judge.*

This is an appeal from a district court order of March 26, 1969, authorizing the Reorganization Trustee of the Central Railroad Company of New Jersey to pay for the removal of a damaged portion of the Newark Bay Drawbridge with funds drawn down from a special account held for the benefit of the Railroad's bondholders.[1]

On March 22, 1967, the district court granted the petition of the Central Railroad Company of New Jersey for reorganization, pursuant to § 77 of the Bankruptcy Act, 11 U.S.C. § 205 (1964). On October 13, 1967, the court established Special Account No. 3 for the protection of the holders of The General Mortgage bonds, into which all proceeds from the disposition of real property, subject to such mortgage, for amounts exceeding $10,000. were to be placed. Special Account No. 3 "is the account in which the Trustee deposits all proceeds of sale, salvage or other disposition of real property covered by the lien of the Debtor's General Mortgage (except items involving $10,000.00 or less in any one transaction), which proceeds are normally withdrawable by the Trustee to pay for needed additions and betterments to, or the purchase of, other real property, which would be or become subject to the lien of the General Mortgage."

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[1] The order provided:

> "[T]he Court concludes that the Trustee is authorized to enter into a contract . . . for the removal and disposition of the damaged portion of the north span of the Newark Bay Drawbridge, and to draw upon the funds in Special Account No. 3 for the payment of the same."

Appendix B

The order challenged in this appeal authorized payment for the removal of a damaged span of the Newark Bay Drawbridge, which is the Railroad's only rail link between Bayonne—Jersey City (parts of the Port of New York) and the remainder of its system. On May 19, 1966, the Steamship *Washington* collided with the Drawbridge, rendering both the north and south spans inoperative. Approximately $214,000. was expended by the Railroad to make the south span operative, and $49,000. was expended to support the north span which was left in a raised position; additional work on the south span at an estimated cost of $216,000. was deferred. In addition, because of the necessity to reroute its rail traffic while the south span was being repaired and the loss of revenue incurred during this period, the Railroad suffered $192,000. in consequential damages. On September 10, 1968, the court approved a settlement of $750,000., in full satisfaction of the Railroad's claims arising from the *Washington's* collision with the bridge.[2]

Following the settlement it was determined that there was no further need for the north span and that the support to such span added after the collision was insufficient protection against the possibility of its collapse. If it contined to stand in its weakened condition, it would be a hazard to navigation on the river below and to the south span of the Drawbridge next to it. The Reorganization

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[2] The court allocated approximately $455,000. of the $750,000. to expenses and consequential damages actually incurred by the Railroad. The remaining $295,000. received by the Reorganization Trustee was placed in Special Account No. 3, as partial compensation to the holders of the mortgage bonds, reflecting the difference between the pre-collision value of the Drawbridge and its value after being damaged and repaired. No part of the settlement was allocated to anticipated repairs of the south span.

Appendix B

Trustee therefore advertised for bids for the removal of the damaged portion of the north span. The low bid was $385,000., an offer that was open to acceptance only until March 31, 1969. Related costs of the Railroad raised the total amount necessary for removal to $408,000. On January 21, 1969, the Reorganization Trustee petitioned the court for authority to accept the offer, the total cost of $408,000. to be drawn from Special Account No. 3.

The district court found that the expenditure would be for a "betterment to the economic and efficient operation of the railroad,"[3] since it was necessary for the preservation of the south span and to the continued operation of the Railroad. It also found specifically that (1) there was "an immediate and urgent need" for the removal of the damaged portion of the north span, (2) no sources other than Special Account No. 3 were available to meet this need, (3) reorganization of the Railroad was "probably feasible," and (4) the interests of the bondholders would not be prejudiced by granting the petition. Accordingly, the court authorized the Reorganization Trustee to enter into the contract for removal and to draw upon the funds in Special Account No. 3 for this purpose. No obligation to repay the $408,000. was imposed.[4]

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[3] The district court used this language:

> "It may be argued that this expenditure is not for a 'betterment' in the classic sense of the word; however, this Court has no doubt that the expenditure is necessary for the preservation of the property of this estate; it is, therefore, a betterment to the economic and efficient operation of the railroad."

[4] The Indenture Trustee did not move for a stay of the order, and the contract was executed before the March 31, 1969, deadline. At the time of argument before this court, the contract had been completed and the entire $408,000. had been drawn down from Special Account No. 3.

Appendix B

Under the Bankruptcy Act, the Reorganization Trustee is vested with the right to immediate possession of all the debtor's property. Bankruptcy Act § 257, 11 U.S.C. § 657 (1964). The incidents of this right, however, are not unlimited. The right of the trustee to the use of property to which a lien attaches, such as the funds in Special Account No. 3, to finance betterments was described by Judge Anderson in *In re New York, New Haven & Hartford Railroad Co.*, No. 30226 (D. Conn., 12/7/61):

> "The rule for a reorganization under Sec. 77 . . . is that in addition to finding that the funds are presently needed and cannot be obtained elsewhere, the court need only conclude that reorganization is probably feasible, that the money drawn-down and expended for additions and betterments will materially contribute to the possibility of successful reorganization and to the continuation of the transportation plant, or a substantial part thereof, as a going concern, and that the interests of the bondholders are not thereby prejudiced." (Appellant's brief, at 28).

Similar factors are considered in Chapter X reorganizations, if the mortgaged property is to be expended to finance betterments. See, e.g., *Harding* v. *Stickman*, 240 F. 2d 289 (2nd Cir. 1957); *Reconstruction Fin. Corp.* v. *Kaplan*, 185 F. 2d 791 (1st Cir. 1950).

The funds taken from Special Account No. 3 in this case, however, were not expended for "additions or betterments."[5] They were expended to remove mortgaged

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[5] We note that under circumstances such as these, where the findings are of ultimate, rather than evidentiary, facts and are in the nature of conclusions, the limits of Rule 52(a) of the Federal Rules of Civil Procedure on the scope of appellate review do not apply. See, e.g., *Soles* v. *Franzblau*, 352 F. 2d 47 (3rd Cir. 1965); *Stevenot* v. *Norberg*, 210 F. 2d 615 (9th Cir. 1954).

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property, not to replace or add to it. Certainly the expenditure inured to the benefit of the bondholders, since removal of the damaged portion of the Drawbridge protected the operative south span, thus insuring that the Railroad would not suffer another stoppage of service. And there is no doubt that the "going concern" value of the Railroad to the bondholders was greater than its liquidation value, had a stoppage of service prevented reorganization. But like insurance or any other expenditure that keeps the Railroad operating, this was an operating expense.[6] The crucial consideration in classifying an expenditure as being for an addition or betterment is whether such expenditure increases the value of mortgaged property by adding to the operational plant.[7] In this case,

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[6] The parties apparently stipulated that the Interstate Commerce Commission would classify the expenditure for removal and disposal of the damaged span as an operating expense under its Uniform System of Accounts for Railroad Companies.

[7] Thus, in the *New Haven* case, *supra*, the expenditure involved "money for the repair facility at Stamford, the trestle at Bridgeport, the freight house at Stamford . . . ." In *Harding* v. *Stickman*, *supra*, the railroad purchased new railroad cars. In *Reconstruction Fin. Corp.* v. *Kaplan*, *supra*, the court allowed the trustee to complete the manufacture of unfinished watches so that they could be sold for the Christmas season, thereby increasing the total property of the debtor. The court in *In re New York, N. H. & H. R. R.*, 289 F. Supp. 451, 455 (D. Conn. 1968), allowed the debtor to continue deficit operation, but the deficit did not involve the expenditure, without substitution, of mortgaged property. The order in that case of December 19, 1967, cited by appellee, did allow the disbursement of mortgaged funds for operating expenses, but only on the condition that the United States Government substitute property with a value equivalent to that withdrawn.

the Reorganization Trustee was authorized to draw $408,000. from the bondholders' account; the Indenture Trustee, representing the holders of the General Mortgage bonds, was given no substitute property in exchange and no property under lien was increased in value through physical additions thereto. The expenditure was not for "an addition or betterment."[8]

The leading case in a situation where the trustee is authorized to draw down mortgaged funds to pay for operating expenses is *In re Third Avenue Transit Corp.*, 198 F. 2d 703 (2nd Cir. 1952). The Indenture Trustee appealed from an order authorizing the Reorganization Trustee to draw down $500,000. from the mortgaged funds account[9] for "working capital" in order "to continue operations." *Id.* at 705.[10] In return, the Indenture Trustee received from the Reorganization Trustee a certificate bearing 1¾% interest, the times and amounts of repay-

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[8] The Reorganization Trustee made no showing that the value of the bridge structure without the damaged north span was greater than the value of such structure with the damaged span in place. At the time of the settlement, it was estimated that repairs necessary to put the north span in operative condition would cost $700,000. The court's order leaves the Indenture Trustee with a bridge of uncertain value and a cash fund diminished by $408,000.

[9] The account consisted of proceeds from the sale of mortgaged real property, similar to Special Account No. 3.

[10] The court characterized the draw-down as cash that "could be readily dissipated by improvident trustees, leaving the bondholders nothing of any substantial value in return." 198 F. 2d at 706, n. 7. In contrast, the operating expense in the instant case was carefully examined and limited.

ment to be settled by further court order on the application of either party. The Second Circuit established the test for such an order:

> "[T]he court's far more drastic power under Section 257 [to authorize the reorganization trustee to take possession of any or all property of the debtor], requires proof of the most extraordinary circumstances . . . . [W]e believe that that power should never be exercised absent findings, based on the clearest evidence, not only that it is imperative to obtain the funds and that they cannot be obtained . . . through ordinary market channels . . ., but also that there is a high degree of likelihood (a) that the debtor can be reorganized in accordance with the Act, within a reasonable time, and (b) that the secured creditors whose security is being compulsorily loaned will not be injured. The reorganization trustee here had the burden of proving all these matters." *Id.* at 706-07 (footnotes omitted).

Because the district court had made no such findings and because no evidence was introduced to support such findings, if made, the order was reversed.

Although the district court in the instant case made findings, its findings complied with the test set forth by Judge Anderson in the *New Haven* case, *supra,* not the stricter test set forth by the Second Circuit in the *Third Avenue* case, *supra.*[11] We need not determine, however,

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[11] The district court found only that reorganization was "probable" and that the bondholders would not be "prejudiced" by the order. *Third Avenue,* however, requires a finding of a "high

(*Footnote continued on following page*)

whether the § 77 standard applied in *New Haven* to betterments or the Chapter X standard applied in *Third Avenue* to operating expenses should be applied to this case, a § 77 reorganization involving the draw-down of mortgaged funds for operating expenses. The Indenture Trustee does not contend that no funds should have been drawn down from Special Account No. 3;[12] it contends only that some

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(*Footnote continued from preceding page*)

degree of likelihood" of reorganization and of non-injury to the bondholders. As Judge Anderson stated in the *New Haven* case, *supra*,

> "These criteria [in the *Third Avenue* case] . . . appear to call for a finding by the court, as prerequisite to a granting of leave to the trustees to draw-down funds from the registry of the court for working capital, that there exists *almost absolute certainty* of successful reorganization and *almost a guaranty* that no loss will be suffered by the bondholders by reason of the draw-down." (Emphasis added) (Appellant's brief, at 26)

Cf. *In re Riker Del. Corp.*, 385 F. 2d 124, 126 (3rd Cir. 1967), where this court, dealing with a Chapter X reorganization of a corporation holding real estate, stated that the secured creditors, in return for a turn-over order, should expect a "real prospect of compensating advantage . . . through a successful reorganization."

[12] The Indenture Trustee argues that the district court was clearly erroneous in finding that no source of funds was available for the removal and disposal of the damaged north span, because it was willing to lend the required funds out of its holdings in Special Account No. 3. This argument misconstrues the nature of the *Third Avenue* and *New Haven* proceedings. The issue in both those cases was whether funds should be drawn from the account of the bondholders. Both courts held that such a draw-down was impermissible if funds could be obtained from sources *other* than the account of the bondholders. It is conceded here that there were no sources of funds other than those in Special Account No. 3, and therefore the test of unavailability of outside funds was met.

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obligation be imposed upon the Reorganization Trustee to repay the compulsorily lent funds to Special Account No. 3. We agree.

Prior to the district court's order, the Indenture Trustee possessed a mortgage lien upon the funds in Special Account No. 3. This bondholders' lien had priority over the claims of operations creditors.[13] The order, however, released $408,000. from the stockholders' lien, thus making that amount available to satisfy the priority of operations

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[13] Judge Anderson provided an excellent discussion of the law regarding creditor priority in *In re New York, New Haven & Hartford Railroad*, 278 F. Supp. 592 (D. Conn. 1967). That case involved the claim of operation creditors whose claims had arisen in the period immediately preceding reorganization. The court recognized the general rule that operations revenues must go first to those who keep the railroad running, the operations creditors:

> "Revenues accruing from operations should be paid first to the operations creditors whose materials and services made those revenues possible; and only after such operational claims have been paid should the balance be available for the benefit of the mortgagees. If any operating revenues do improperly get into the hands of the mortgagees, equity requires that those revenues be restored to the operations creditors by the mortgagees yielding them a priority." *Id.* at 597-98.

The principle of this priority, however, applies only to operations revenues. Property subject to mortgage liens, or "corpus," *id.* at 595 n. 1, "cannot be invaded to satisfy the priority of the operations creditors." *Id.* at 602. This latter rule does not apply if operations expenses have been "diverted" to the benefit of the bondholders, but "benefits accruing to the bondholders" is defined as *not* including benefits paid for by "proceeds from the sale of mortgaged property." *Id.* at 603-604.

creditors.[14] Equity demands that the bondholders be given a guaranty that their lien upon this money be maintained, and that the money be repaid as soon as reasonably possible. Cf. *In re Riker Del. Corp.*, 385 F. 2d 124, 125 (3rd Cir. 1967).

Therefore, the District Court order of March 26, 1969, will be reversed and that court will be directed to enter an order

> (1) imposing upon the Reorganization Trustee an obligation in favor of the Indenture Trustee, ranking on a parity as to lien and priority with any other obligations (except Trustee certificates approved by the Interstate Commerce Commission) heretofore or hereafter incurred by the Reorganization Trustee, for repayment of the $408,000. principal drawn-down from Special Account No. 3, in such instalments as the District Court shall determine to be reasonable, any part of such $408,000. principal so repaid to have the same status as other funds in Special Account No. 3;
>
> (2) providing for interest payments on all of the above-mentioned $408,000. from the date or dates of its payments by the Indenture Trustee and on such parts of this $408,000. as have not been repaid in the future at such rate as the District Court shall determine from time to time, but in no event shall such rate be less than the average rate of return

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[14] See, e.g., *Pennsylvania Steel Co.* v. *New York City R. R.*, 216 Fed. 458, 471 (2nd Cir. 1914), cert. den. 238 U. S. 632 (1915); *In re New York, N. H. & H. R. R., supra,* note 13, at 602.

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on the principal funds within Special Account No. 3,[15] the obligation to pay such interest ranking on the same parity as to lien and priority as is specified in (1) above; and

(3) providing that the interest paid on the above-mentioned $408,000. and parts thereof, prior to repayment of the principal producing such interest, shall be income of the Indenture Trustee.[16]

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Court of Appeals for the
Third Circuit

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[15] In the *Third Avenue* case *supra*, the lower court had ordered repayment of the compulsory loan with 1¾% interest. In holding that the loan was improper, the court stated:

> "Although our decision here would be the same in the absence of the following facts, we think it important that they be noted: (1) The terms of the certificate issued to the involuntary lender—i.e., the noncommercial interest rate and the lack of a fixed maturity date—were peculiarly unfortunate. . . ." 198 F. 2d at 707, n. 15.

[16] At oral argument counsel indicated that there is some dispute over whether the interest presently accruing on the funds in Special Account No. 3 should be paid to the Reorganization Trustee. While we make no resolution of that dispute, we think it proper that, in order to encourage prompt repayment of the $408,000., the Reorganization Trustee's obligation to pay interest on the $408,000., which will be receivable as income of the Indenture Trustee, should be clear.

APPENDIX C

Section 257 of the Bankruptcy Act, 11 U.S.C. § 657

"The trustee appointed under this chapter, upon his qualification, or if a debtor is continued in possession, the debtor, shall become vested with the rights, if any, of such prior receiver or trustee in such property and with the right to the immediate possession thereof. The trustee or debtor in possession shall also have the right to immediate possession of all property of the debtor in the possession of a trustee under a trust deed or a mortgagee under a mortgage. July 1, 1898, c. 541, § 257, as added June 22, 1938, c. 575, § 1, 52 Stat. 902."